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Financial Markets

Irving Trust

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Exhibiting a clear tendency toward fickleness, the Fed funds market has run amok and given the Fed problems. Wednesday, June 20 (a settlement date), the funds rate averaged 12.31%. The next day, funds held at an average of 11.90%; this past Wednesday, June 27, funds averaged 10.51%. This creates quite a trading range. Clearly the 12.31% can't be chalked up to settlement pressure alone, given what occurred the next day. So what's going on? Has the Fed tightened again, or hasn't it?

The Fed has tightened, probably enough to keep funds above the 11% level on a persistent basis. However, the strong funds rates of the past calendar week have their roots in something else: market psychology. The recently released GNP numbers (the revision for the first quarter and the "flash" estimate for the second quarter) affected the Fed funds market greatly. As a result, participants became more sensitive to Fed activity and feared that more Fed squeezing of reserve positions was on the way. But at the same time, the Fed was in the midst of a reserve control problem: On the five business days from June 18-June 22, the Fed executed multiday or overnight System RPs on each day. The Fed was actively adding reserves to combat a rising trend in the funds rate and a reserve-deficient banking market.

On Wednesday, June 20, $6.4 billion of System RPs were outstanding. One thing this meant was that those RPs would be running off and draining reserves at the start of the new week. Thus the Fed stepped in on Thursday and Friday at the start of the new reserve maintenance period to add reserves (neutralize the drain). Undoubtedly, part of the reason for adding was the high Fed funds rates experienced--not just the maturing RPs. But the System RPs had little effect on Fed funds before the weekend. At the time, the RPs seemed a weak effort meant to mollify the market. But after the weekend, things changed. It began to look like the Fed had pumped some real liquidity into the market. The Fed funds rate dropped sharply. But by late Thursday (June 28), Fed funds were back near 11%.

In retrospect, the Fed's adding of reserves on June 21 and 22 seems to have been a rate motivated action. Possibly the Fed's own reserve projections did not indicate a reserve need. However, the Fed was "forced" to act to keep funds from exceeding their established band on a persistent basis (probably still 11.5% at the top). But after the markets digested the GNP numbers and a more reasonable psychology ensued, the reserves that had been injected took effect, and Fed funds began to plummet.

This story has several morals: Remember that the Fed operates using reserve projections; it doesn't see all and know all. Never underestimate the power of market psychology even in a strongly supply/demand determined market like Fed funds. Realize that Fed funds rates can swing widely, and that movements in Fed funds are hard to interpret. And remember that my interpretation still sees the Fed tightening.

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Market Yields

	6/29/84 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	13.00%	12.50%	10.50%
Effective since	6/25/84		
Discount Rate at Federal Reserve Bank	9.00	9.00	8.50
Federal Funds	11.25	11.69	9.38
Repurchase Agreements	10.00	10.38	9.38
U.S. Treasury Issues			
Bills			
3 months	10.34	10.30	9.07
6 months	11.23	11.43	9.43
1 year	12.70	12.37	9.63
Coupons			
2 years	13.18	13.22	10.23
4 years	13.65	13.61	10.63
7 years	13.79	13.73	10.92
10 years	13.82	13.77	10.94
Long Bond	13.62	13.62	11.00
Negotiable Certificates of Deposit-Secondary Market			
1 month	11.40	11.50	9.10
3 months	11.75	11.75	9.20
6 months	12.15	12.20	9.45
1 year	13.00	13.00	9.85
Banker's Acceptances			
1 month	11.46	11.62	9.05
3 months	11.95	12.00	9.15
6 months	12.35	12.43	9.45
Eurodollar Deposits			
1 month	11.88	12.13	9.50
2 months	12.00	12.25	9.63
3 months	12.25	12.75	9.63
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	11.18	10.80	9.02
1 month	11.39	11.26	9.19
3 months	11.31	11.25	9.34
Bank Holding Companies			
1 month	10.89	10.89	9.07
Dealer Placed:			
3 months	11.68	11.84	9.43
New AA Corporate Utility Bond	14.88	14.75	12.15
Tax Exempt			
6 month Project Notes	5.75	5.75	4.75
1 year AAA Bond	6.50	6.00	5.50
5 year AAA Bond	8.00	8.05	7.00
20 year AAA Bond	10.20	10.00	9.40

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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